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Keith Salmon, University of Hertfordshire

# Boom to bust – Reconstructing the Spanish economy
# Part Two: Policy Responses to the Economic Crisis


## ABSTRACT

Recession in Spain led to intervention by the government to stimulate the economy, a response that was replicated around the world. But as public finances deteriorated, financial markets and some policy makers demanded credible austerity measures (exit strategies) to reduce growing public sector debts. There was particular external pressure on Spain since any sovereign debt default would have serious repercussions at least throughout the European Union. Thus, from autumn 2009 stimulus measures began to be withdrawn and replaced by austerity ones. In addition, recession high- lighted fundamental weaknesses in the Spanish economic model. Part one of this article (Salmon 2010) charted the passage of the Spanish economy into recession through examining key three features that were specific to Spain, the financial system, conditions in the property market, and the exceptional level of unemployment. The second part examines the macroeconomic policy measures taken in Spain and the outlook for a new economic model. It concludes that Spain had little alternative but to severely tighten fiscal policy and that a new economic model will be evolutionary rather than revolutionary.


KEYWORDS austerity measures economic model exit strategy Spanish economy stimulus measures

## INTRODUCTION

As the economic crisis gathered momentum in 2008 the response by governments in western industrialized countries was to introduce economic stimulus measures through fiscal and monetary loosening. The Group of 20 summit meeting in Pittsburgh in September 2009 declared that member countries would 'sustain our strong policy response until a durable recovery is secured' (G20 2009). But as global growth prospects improved and debt problems in Europe threatened not only to destabilise Europe but the global economy, the emphasis shifted to tightening fiscal policy and implementing debt reduction strategies. Thus the Group of 20 summit in Toronto in June 2010 ended with an ambiguous declaration that supported a variable response, allowing for both immediate policy tightening (as was being adopted in Europe) and postponement of tightening (as was being adopted in the United States). Beyond this debate over macroeconomic policy (see Financial Times 2010) lay a much more profound one over the future of capitalism (see, e.g., Kaletsky 2010) and the economic model for the twenty-first century. The following discussion looks at how these debates were played out in Spain.

## THE POLICY RESPONSE

Successive Socialist (PSOE) governments attempted to embrace economic and fiscal conservatism (as implemented by Pedro Solbes until he left the government in April 2009) with social liberalism, in which a process of social dialogue was adopted to try to achieve key changes. From the onset of the economic slowdown this political perspective was translated into policy responses through a series of stimulus packages and ad hoc measures amounting to one of the largest fiscal stimuluses in the EU and above the average in the OECD, implemented from April 2009 by a new minister of finance, Elena Salgado. BBVA (2009) estimated that the discretionary fiscal measures introduced between 2008 and 2009 were worth €50 billion; adding the impact of 'automatic stabilisers' such as increased welfare payments (for example unemployment benefits doubled between 2007 and 2009 to some €32 billion) then BBVA estimated the total stimulus to be worth 11.8% of GDP, over twice the EU average. In addition, monetary policy as set by the European Central Bank (ECB) provided a low-cost lending window for banks and took interest rates down to record low levels in late 2008 and 2009 (the twelve month euribor rate falling from a peak average of 5.38% in September 2008 to 1.33% in August 2009), providing additional disposable income for those with debts (especially those with outstanding mortgages). In spring 2010, as fears grew over sovereign debt and the stability of the Spanish financial system, wholesale money markets stopped lending to Spanish banks, the ECB was increasingly not just the 'lender of last resort' but the lender of only resort'. Measures to ensure the stability of the financial system (notably the FROB) were the most important and potentially the most costly for the public purse (these measures were also supported by actions taken by the ECB). Among the other measures the most important by value were a tax refund to all income taxpayers in 2008 and 2009 and funding in 2009 and 2010 to boost local authority infrastructure spending (the FEIL). The tax refund of €400 per income tax payer was estimated to cost some €12 billion over 2 years, but this may have been used more to reduce debt and rebuild savings than to stimulate spending. Probably the most effective short-term measures were the funds to boost local authority infrastructure projects in 2009 and 2010 (worth €8 billion and €5 billion, respectively). In 2009 alone, funding was projected by the government to create over 200,000 jobs and may in practice have created many more (although many of these jobs were of short duration). In addition to these measures introduced specifically to counter the crisis, tax reductions decided on before the crisis were feeding through into the economy during 2008 and 2009 (e.g., corporation tax and income tax reforms).

**Table 1: Economic stimulus measures introduced 2008 to spring 2010**

| Sector | |
|---|---|
| Financial System | Enhanced deposit and investment guarantee fund (Fondo de Garantía de Depósitos y del Fondo de Garantía de Inversiones, FGDGDI) |
| | Fund to buy financial assets should the need arise (Fondo para la Adquisición de Activos Financieros, FAAF) |
| | Fund to Support restructuring in the banking sector (Fondo de Reestructuración Ordenada Bancaria, FROB) |
| Infrastructure | Bringing forward infrastructure projects Fund for investment by local authorities (Fondo Estatal de Inversión Local, FEIL) |
| Fiscal Measures | Numerous measures introduced, the largest being an income tax rebate for all taxpayers in 2008 and 2009 |
| Support for small businesses | Numerous measures including government sponsored loans |
| Support for the housing market | Measures mainly to promote the rental sector |
| Specific sector measures | Notably aid to support the motor-vehicle industry (Plan 200E) |
| Support for vulnerable social groups | Measures for example to support the unemployed and those with mortgage repayment difficulties |
| Support for labour mobility | Increased investment in retraining and promotion of the rental housing sector |
| Structural measures | Transposition of the European Services Directive and proposals for a law promoting a sustainable economy (Ley de Economía Sostenible) |

Source: Author compilation

From autumn 2009 the stimulus measures began to be withdrawn and austerity measures introduced, first in the Consolidated State Budgets for 2011, then in a number of austerity packages in early 2010 (including the Plan de Acción Inmediata 2010 and Plan de Austeridad 2011–2013) and finally in the 'Plan de medidas extraordinarias para reducir el gasto público' in May 2010. In total, tax increases and spending cuts added up to one of the most severe austerity packages in Europe, designed to cut the budget deficit from 11.2 per cent in 2009 to 3 per cent in 2013. Year-on-year increases in government revenue and public spending reductions were required to meet the target in a political economy where regional governments were now responsible for a large pro- portion of public spending, where unemployment was already at exceptionally high levels, where little growth was forecast in the near future and where the government relied on minority parties to pass legislation.

Structural measures were initially more limited, confined mainly to transposing the European Services directive (Directive 2006/123/EC) into law (marking another step in opening the service sector to a greater degree of com- petition) and proposals for a sustainable economy law (Ley de Economía Sostenible; MEH 2009). But as external economic and political pressures grew, progress was made with more fundamental structural reforms, notably reform of the regulations governing savings banks (Lorca 2010; BOE 2010a), reform of the labour market (Real Decreto-ley de medidas urgentes para la reforma del mercado de trabajo; BOE 2010b), and proposals over reform of the pensions sys- tem. Such reforms, along with the stiff austerity measures, provoked increasing popular resistance (as expressed in strike action and anti-government demonstrations) and demands from the opposition during the State of the Nation debate in July 2010 for the resignation of the government. Implementing the austerity plans would clearly be difficult in the face of popular discontent, political opposition and the pattern of decentralised government.

In sum, the forces at work to both stimulate and contract the economy in 2008/09 were enormous. Developed market economies faced a downward spiral of contraction. Against this were the powerful stimulus measures applied by many governments, especially in the US, the UK, in China and Spain. By the second quarter of 2009 stimulus measures appeared to be stabilising economies. But these measures were introduced at enormous public cost and were temporary. By mid-2009 all governments that had introduced stimulus measures were seeking exit strategies to rebuild their public finances and maintain a path to recovery. The debate was largely over timing, tighten immediately (as in Europe, see Trichet 2010) or postpone tightening until growth was more established (as in the United States, see Summers 2010). Given the market and political pressures facing Spain in early 2010 (including fear over a potential break-up of the eurozone), Spain had little option but to tighten early. This required immediate and on-going cuts in public spending and tax increases. There was a serious political risk that the government would lose support and be forced from office, and an economic risk that the measures would derail recovery. Recovery was fragile and the shape of any economic recovery difficult to predict.

**TOWARDS A NEW ECONOMIC MODEL**

The outline of a long-term response to the economic crisis was emerging by mid-2009 (for details of a comprehensive government view see, for example, the draft law on a sustainable economy; MEH 2009). Firstly, the hegemonic philosophy of unfettered markets (market fundamentalism) was no longer accepted as the sole mechanism for creating long-term sustainable growth (see e.g. Kaletsky 2010). Following the fall of Lehman Brothers in September 2008, the French president Nicolas Sarkozy (2008) said: 'laissez faire, c'est fini'. Similarly, the Spanish vice-president, Fernández de la Vega, was quoted in early September 2009 as saying that the blame for the crisis should be on those that: 'creyeron que el Mercado lo solucionaba todo' (Cinco Días 2009). The philosophy was never accepted in China and India and was viewed with scepticism in those emerging economies that had suffered their own serious financial crises. Careful regulation, especially in the financial sector, was essential as part of any liberalisation process. Secondly, although unconstrained liberalisation was potentially destabilising, further liberalisation of the economy (notably in the service sector and labour market) along with institutional reform was necessary to improve competitiveness and enable the economy to adjust more quickly to change. Thirdly, a model of growth based on high levels of consumer debt and property development was not a sound base for sustainable growth. Fourthly, continued low productivity and low levels of investment in research and development undermine competitiveness. Spain could only compete in the world economy through productivity improvements, improved quality, innovation and more technologically advanced products and services. This required more investment in research and development together with a more skilled labour force (in 2009 the OECD published figures showing that students in Spain completed an average of only 10.6 years of schooling compared with 13.4 years in Germany and 13.3 in the United States; OECD 2009a). Finally, a new model will reflect concerns over climate change (see Plan Nacional de Adaptación al Cam- bio Climático; Ministerio de Medio Ambiente 2008), water (for discussions on climate change and water in the economy, see Lopez-Gunn 2009) and energy security, it will thus be more energy efficient and rely more on renewable power (see OECD 2009b). These types of changes were implied in repeated calls for a new economic model. For example, in August 2009 the Secretary of State for the Economy, José Campa, said in an interview with Cadena SER (Cadena ser 2009) that: 'lo más importante en estos momentos es crear un nuevo patrón de crecimiento para la economía española .. .' Less clear was exactly how this model would be created: how structural change would be financed; where the boundary of the public sector would be drawn; what would be the nature of the welfare state in the new model; and what would be the constitutional form of the state.

Any new economic model had to emerge from the existing cultural con- text, institutional and economic structures, and as such would be partly 'path dependent'. In the first quarter of 2010 the employment structure (those in employment) comprised 4.5 per cent in agriculture, forestry and fishing; 14.1 per cent in industry (less than 13 per cent in manufacturing if energy and mining were excluded); 9 per cent in construction; and 72.3 per cent in services (INE 2010). Growth in the next decade was therefore likely to be driven essentially by services.

Employment in the primary sectors of mineral extraction, fishing, forestry and agriculture continued to fall. Mineral extraction was restricted by the lack of economically recoverable deposits and planning restrictions, fishing by dwindling fish stocks (although fish farming may expand), forestry by planning and land ownership restrictions, and agriculture by water supply problems, rising costs of production and low-cost overseas competition.

Similarly, employment in manufacturing remained on a path of employment contraction as cheaper production platforms outside Spain monopolised mass production that used established technologies to produce products for the global market and as these platforms developed the capabilities to produce more technologically advanced and higher quality products. According to the Labour Force Survey (INE 2010) from the first quarter of 2007 to the first quarter of 2010 industry lost 665,000 jobs, employment shrinking by over 20 per cent from 3.3 million to 2.6 million. It was particularly difficult to hang on to some manufacturing in basic metals, 'textiles, clothing and shoes' (which by 2010 had lost over half the jobs it provided in 2000), furniture, toys and even some businesses in the transport sector (e.g., shipbuilding). One hurdle to growing high-technology manufacturing was the small size of this segment. According to the Labour Force Survey (INE 2010), in the first quarter of 2010 the pharmaceutical, 'informatics, electronics and optical equipment' and electrical equipment industries employed only 190,000 (8% of those in manufacturing), the transport sector a further 279,700 (12% of those in manufacturing). Even in new technology areas manufacturing was difficult to retain in Spain. For example, alternative energy technologies (such as wind turbines and solar panels) were frequently cited as new shoots for manufacturing growth. But production capacity for these was expanding in emerging markets. Hence, businesses were being forced either into the upstream or the downstream segments of the manufacturing supply chain: research & development, design, marketing, distribution, retailing, after-sales and logistics. Even in these segments com- petition was growing as businesses in emerging markets attempted to capture more of the supply chain (Rosen and Heineman 2009).

In construction, the domestic industry remained cyclical. It was unlikely that the domestic construction and property sector would ever regain the significance they developed in the first decade of the century, since at that time the sector was buoyed by the combination of factors mentioned above plus major public works associated with real public infrastructure weaknesses and financial transfers from the EU.

Services continued to become an even larger part of the economy, many in the non-traded sector. In the traded sector, Spain had developed internationally competitive businesses in architecture, banking, construction, design, energy, infrastructure management, retailing, telecommunications, tourism, urban services and water. These had benefited from a degree of protection in the domestic market and a lack of effective competition in many emerging markets. Both of these advantages were being squeezed as liberalisation opened up the domestic market and businesses in emerging economies became more competitive. Nevertheless, these services were likely to form the structural basis of a rebuilt economy.

Overseas, Spain had established a competitive advantage in Latin America derived from its cultural links with the region and the experience its businesses gained from the privatisation process at home that was applied to privatisation opportunities in the region (Chislett 2002, 2003; Guillén 2005). Access to one of the world's most widely spoken languages continued to provide a competitive edge in Latin America while increasing cross-border experience supported expansion elsewhere in the world. The new economic model appeared set to be more open, with increased foreign ownership of businesses in Spain and policy support for further internationalisation by Spanish companies (support for the latter also came from many economic commentators; see e.g. Chislett 2010).

Finally, research and development, innovation and a more skilled and flexible labour force were generally cited as key elements in any new model. From a very low base of investment in research and development and from very low patent registrations on innovation some progress had been made. But public spending to support R&D was hampered by requirements to rebuild public finances. At the same time, private sector spending was restricted by the composition of businesses in Spain, their ownership and their own financial positions. Thus a dramatic turn-a-round in these areas could not be expected. Equally, the institutional reforms necessary to improve the efficiency of the labour market, the public administrations and the education system were unlikely to be achieved quickly.

## CONCLUSION

At the end of the first decade of the twenty-first century Spain was a medium size open economy. Growth was inextricably bound-up with that of the European Union and the world, and the pattern of growth with existing economic and institutional structures in Spain. But domestic policy actions were also shaping recovery and the architecture of the evolving political economy.

The development path was in large measure determined by the structure of the existing economy and by the investment decisions made by businesses, particularly transnationals in relation to how they structured their global supply chains. These decisions were influenced by the business environment in Spain and its relative attraction compared with that of other locations. Shaping this environment, however, was a crucial government responsibility. Beyond this, the government had to decide how far it would go in providing more active support for structural adjustment. Thus, the new economic model embraced an important role for the government.

The financial sector boasted two major transnational banks that looked set to become larger and more geographically diversified. In the savings bank sector market pressures and state encouragement were driving consolidation, although it remained to be seen how successful a process of rapid consolidation, shaped in part by local political interests, would be. The outcome was not only critical for the financial system, it would also contribute to the nature of the emerging constitutional form of the state.

In the property market the overhang of unsold properties was likely to depress property prices and impede recovery at least through to 2011. Construction work was initially cushioned by public works, although this became more difficult to finance through public funding. New mechanisms would have to be sought to attract private funds. Beyond 2011 the property and construction sector would begin to recover, but it was unlikely to develop to the same scale that it enjoyed in the early years of the first decade. This would provide space for investment in more productive activities.

Unemployment continued to rise into the first half of 2010. Absolute numbers unemployed were the highest ever recorded in Spain and the rate too approached the levels of the early 1990s. Exceptionally high unemployment would remain a problem for several years, posing serious challenges for individuals, society and the government.

Finally, economic crises generally led to paradigm shifts in economic management: the late 1970s witnessing a shift from Keynesianism to monetarism and more reliance on markets; the early 1990s to a focus on the Maastricht criteria and inflation targeting (Kaletsky 2010). The short-term response to the credit crisis was towards a dramatic increase in state intervention, the ‘Washington consensus’ and ‘market fundamentalism’ appeared to be dead. But it was not clear what the new form of management would look like in the second decade of the twenty-first century. There were renewed arguments for greater government involvement in the economy, not least those derived from the experience of high growth in emerging economies in south-east Asia. Yet liberalisation continued to gain ground, tempered by more careful regulation and state self-interest. With regard to economic management, monetary policy was shifting away from simply targeting retail price inflation to embrace a broader range of metrics. On a wider canvas, measures to reduce global economic imbalance (big differences in national savings, consumption and investment rates reflected in large trade deficits and sur- pluses) required adjusting economic policy in states around the world. In Spain and elsewhere in Europe, what the economic crisis was triggering was a re-evaluation of the nature of the welfare state and how this could be sustained. A new economic model was emerging, but it was evolutionary rather than revolutionary.

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**CONTRIBUTOR DETAILS**

Keith Salmon is Reader in Political Economy at the Business School, University of Hertfordshire. He began research on the Spanish economy in the mid-1980s, commencing with work on regional development in Andalucía. In the early 1990s he published a book on the economy of Andalucía and in the same year the first edition of 'The Modern Spanish Economy'. A second edition of this book was published in the mid-1990s. Since that time he has continued to work on the contemporary Spanish economy; including numerous publications, conference presentations and consultancy work.

Contact: Dr Keith Salmon, The Business School, University of Hertfordshire, De Havilland Campus, Hatfield, Herts., AL10 9AB, UK.
E-mail: k.salmon@herts.ac.uk